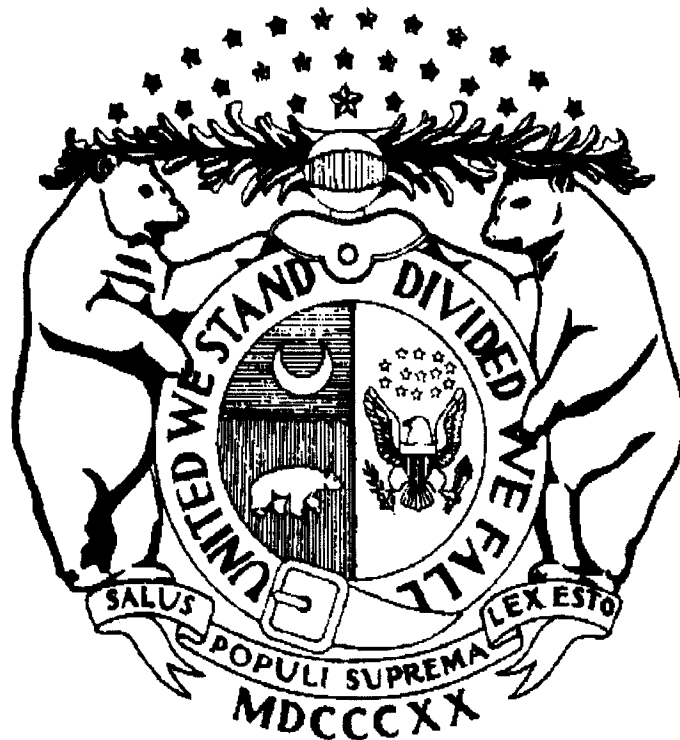


**REPORT OF THE
ASSOCIATION FINANCIAL EXAMINATION OF
FIRST SPECIALTY INSURANCE CORPORATION**

**AS OF
DECEMBER 31, 2003**



**STATE OF MISSOURI
DEPARTMENT OF INSURANCE
JEFFERSON CITY, MISSOURI**

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Overland Park, Kansas
February 8, 2006

Honorable Alfred W. Gross, Commissioner
Virginia Bureau of Insurance
Chairman, Financial Condition (E) Committee

Honorable Jorge Gomez, Commissioner
Wisconsin Department of Insurance
Secretary, Midwestern Zone, NAIC

Honorable Linda S. Hall, Director
Alaska Division of Insurance
Secretary, Western Zone, NAIC

Honorable W. Dale Finke, Director
Missouri Department of Insurance
301 West High Street, Room 530
Jefferson City, Missouri 65101

Ladies and Gentlemen:

In accordance with your financial examination warrant, a full scope association financial examination has been made of the records, affairs and financial condition of

First Specialty Insurance Corporation

hereinafter referred to as such, as First Specialty, FSIC, or as the Company. Its administrative office is located at 5200 Metcalf Avenue, Overland Park, Kansas 66202, telephone number (913) 676-5200. This examination began on August 30, 2004, and concluded on the above date.

SCOPE OF EXAMINATION

Period Covered

The prior full scope association financial examination of FSIC was made as of December 31, 2000, and was conducted by examiners from the State of Missouri representing the Midwestern Zone of the National Association of Insurance Commissioners (NAIC), with the Southeastern and Northeastern zones also participating.

The current full scope association financial examination covered the period from January 1, 2001, through December 31, 2003, and was conducted by examiners from the States of Missouri and Nevada, representing the Midwestern and Western Zones of the NAIC, respectively. This examination was performed concurrently with examinations of the Company's parent, Employers Reinsurance Corporation (ERC), and an affiliate, Westport Insurance Corporation (Westport or WIC). The examination was updated to review the loss reserves recorded as of December 31, 2004.

This examination also included the material transactions and/or events occurring subsequent to the examination date, which are noted in this report.

Procedures

This examination was conducted using the guidelines set forth in the Financial Condition Examiners Handbook of the NAIC, except where practices, procedures and applicable regulations of the Missouri Department of Insurance (MDI) and statutes of the State of Missouri prevailed.

The examiners relied upon information supplied by the Company's independent auditor, KPMG, LLP, of Kansas City, Missouri, for its audit covering the period from January 1, 2003, through December 31, 2003. Information relied upon included confirmations, account reconciliations, and narrative descriptions of processes and controls.

Comments - Previous Examination

The previous financial examination of First Specialty was conducted by the MDI for the period ending December 31, 2000. Listed below are the comments, recommendations, and notes from the previous examination report, the Company's response, and the findings in the current examination.

Conflicts of Interest

Comment: It was noted that several officers and directors did not complete conflict of interest statements during 2000 and 2001. It was recommended that all officers and directors execute a conflict of interest statement annually.

Company's Response: The Company stated that it has implemented an online form for completion, created a repository of conflict of interest statements, and will ensure that all officers and directors execute such statements annually.

Current Findings: Several officers and directors did not complete conflict of interest statements during the examination period. However, the Company has implemented new controls and as a result, it was noted that all officers and directors completed conflict of interest statements in 2004.

Intercompany Agreements

Comment: It was stated that the services provided to First Specialty under the Service Agreement with WIC are exactly the same as the services provided under the Service Agreement with The Medical Protective Company (Med Pro). It was recommended that the Agreements should be either merged into one agreement or each Agreement should be amended to justify why and how each is separate and distinct from the other Agreement with respect to the services provided.

Company's Response: The Company stated that the Agreements are utilized for different lines of business, meaning that merger or amendment likely would create confusion concerning the agreements.

Current Findings: Neither of the Service Agreements were amended or merged during the examination period. However, Med Pro was sold by General Electric to Berkshire Hathaway in May 2005 and therefore, is no longer an affiliate of First Specialty. The Service Agreement with Med Pro is no longer applicable since Med Pro is not providing any current services for FSIC.

Intercompany Agreements

Comment: The Company was directed to terminate any and all intercompany agreements that are no longer being utilized.

Company's Response: The Company stated that it would terminate any agreements no longer being utilized.

Current Findings: Several agreements were identified that had no transactions involving First Specialty during the examination period. Refer to the Intercompany Transactions section of this report for a complete explanation.

Intercompany Agreements

Comment: For any agreements involving several entities, the Company was directed to ensure that costs are properly allocated to the other entities in accordance with the provisions of each agreement.

Company's Response: The Company stated it would ensure that costs are properly allocated to affiliates in accordance with the provisions of each agreement.

Current Findings: No problems were noted with the cost allocations for intercompany agreements.

Intercompany Agreements

Comment: For agreements with GE Capital International Services, Inc. (GECIS), Electronic Data Management International (EDMI), and the related Statements of Work (SOWs), the Company was directed to ensure that accounting for costs is completed and reported in such a manner that payments due or made for each SOW can be individually identified and reported as required by the agreements and MDI's approval thereof.

Company's Response: The Company stated that it had implemented an accounting process for tracking and individually identifying payments for SOWs, and has provided the MDI with payment and savings information as requested or where non-disapproval of such agreements has been otherwise conditioned.

Current Findings: The Company provided workpapers that listed the amount of payments made by FSIC for each of the SOWs with GECIS and EDM I.

Intercompany Agreements

Comment: The Company was directed to ensure accurate reporting and disclosure of all intercompany transactions in the various schedules and exhibits of the Annual Statement, including Schedule Y and the Notes to the Financial Statements.

Company's Response: The Company stated that it would ensure that intercompany transactions are accurately reported and disclosed in the Annual Statement.

Current Findings: The Company could not provide a reconciliation to identify the amounts paid or received by First Specialty for each intercompany agreement that would support the payments with affiliates that were reported in Schedule Y – Part 2 of the 2003 Annual Statement. A further description is included in the Intercompany Transactions section of this report.

Intercompany Agreements

Comment: It was noted that there were instances where intercompany transaction exist without the underlying agreement and required filing and notification of the MDI. Examples were the payroll services provided by Corporate Payroll Relations (CPARS), and the pension services, post-employment pension services, and administration by General Electric Company on behalf of First Specialty. For each of these relationships and other transactions, the Company was directed to draw up the underlying agreement governing the transactions in accordance with the applicable Missouri insurance holding company law.

Company's Response: The Company stated that it had drafted agreements for the above transactions and the agreements had been approved by the MDI.

Current Findings: FSIC and other affiliates executed a Service Reimbursement Agreement, effective April 8, 2004, with GE for the payroll, pension, and employee benefits services provided by GE. Refer to the Intercompany Agreements section of this report for further information on this agreement.

Intercompany Agreements

Comment: It was noted that there were many instances where material intercompany transactions were first implemented by the Company prior to notifying the MDI in violation of the applicable Missouri insurance holding company law. The Company was directed to desist from this practice.

Company's Response: The Company stated that it had identified transactions without underlying agreements, drafted underlying agreements as warranted, and submitted them to MDI for approval as Form D filings.

Current Findings: Intercompany agreements that were entered into during the current examination period were found to have been submitted to the MDI for prior approval, as required.

Insolvency Clauses in Reinsurance Agreements

Comment: The Company was directed to update all of its existing reinsurance agreements so that the insolvency clause in each agreement is in compliance with Missouri Regulation 20 CSR 200-2.100(11)(A), Credit for Reinsurance. The Company was also direct to ensure that future reinsurance agreements comply with this regulation.

Company's Response: The Company stated that it continues to work with the MDI on acceptable language for insolvency clauses to be included in ERC's reinsurance agreements.

Current Findings: As of the date of this report, the MDI and ERC are continuing to work towards an agreement on acceptable language to be included in the insolvency clause.

Reporting Date for Annual Statement Information

Comment: It was noted that the Company's 2000 Annual Statement was based upon a year-end reporting date other than December 31. It was also noted the Company had proposed a year-end reporting date of approximately one week prior to the last business day before December 31 in order to facilitate reporting requirements of the ultimate parent company. It was recommended that the Company consistently apply this plan for a year-end cut-off date in the future.

Company's Response: The Company stated that it has consulted with MDI concerning this issue and will ensure consistent application of its year-end cut-off date plan.

Current Findings: Although there were some inconsistencies, in general, the Company closed its 2003 financial statements, as of December 18, 2003. Refer to the Accounts and Records section for further information.

Coordination for Examination Requests

Comment: It was noted that the Company was unable to comply with Missouri Regulation 20 CSR 200-4.010(4) (Time and Limits) which states that an insurer shall provide, within five (5) working days, any records requested by financial examiners during an on-site financial examination. The following recommendations were directed to enable the Company to comply with this regulation: (1) implement procedures that will facilitate on-site examination in the future, (2) train all personnel who are involved or may become involved in the financial examination process about all aspects of the financial examination process, (3) appoint a senior management person to serve as a general coordinator to facilitate the examination process, (4) add resources that will enable the Company to generate, maintain and retrieve supporting documentation upon request, including information from foreign branches.

Company's Response: The Company stated it has conducted staff education designed to facilitate future on-site examinations, and will conduct additional training in anticipation of the next on-site examination. The Company stated that it will appoint a general coordinator and will designate certain individuals to act as day-to-day contact persons to facilitate future examinations. The Company also stated it has added resources to ensure that foreign branch information can be made available in a timely manner.

Current Findings: There were some lengthy delays to receive some of the information requested during the examination. However, the overall coordination and facilitation of the examination process was improved from the prior examination and was acceptable, considering the size and complexity of the Company.

Information Systems

Comment: It was noted that the review of FSIC's information systems and related environment was significantly hindered by the limited or minimal cooperation exhibited by the staff responsible for this function. The Company was directed to ensure that information systems personnel provide necessary cooperation and documentation in a timely manner.

Company's Response: The Company stated that it ensure that its information systems personnel will provide necessary information in a timely manner during the next financial examination.

Current Findings: No problems were noted in obtaining documentation or cooperation from the information systems personnel.

HISTORY

General

The Company operates as a stock property and casualty insurer in Missouri under the insurance laws of Chapter 379 RSMo (Insurance Other Than Life). First Specialty was incorporated on November 13, 1989 and commenced business on November 21, 1989. The Company has been a wholly owned subsidiary of ERC since its inception.

Capital Stock

The Company's Articles of Incorporation, effective December 31, 2003, allowed for the issuance of 5,000 shares of common stock with a par value of \$1,000 per share. As of December 31, 2003, all 5,000 shares of common stock were issued and outstanding for a total common capital stock balance of \$5,000,000. ERC owns 100% of FSIC's issued and outstanding common stock.

Dividends

No dividends or cash distributions were paid or declared during the examination period.

Management

The management of the Company is vested in a Board of Directors that are appointed by the shareholders. The Articles of Incorporation specify that the number of directors shall not be less than nine (9) and not more than twenty-five (25). All directors at the end of 2003 were employees of the parent, ERC. The Board of Directors appointed and serving, as of December 31, 2003, were as follows:

<u>Name</u>	<u>Address</u>	<u>Position Held with ERC</u>
Ronald R. Pressman	New Canaan, Connecticut	Chairman of the Board, President and Chief Executive Officer
John W. Attey	Shawnee, Kansas	Senior Vice President - Claims, Secretary
Samira Barakat	Kansas City, Missouri	Senior Vice President - Risk Management
Jeanne K. Mason	Overland Park, Kansas	Senior Vice President - Human Resources
Marc A. Meiches	Leawood, Kansas	Executive Vice President and Chief Financial Officer
John C. Narvell	London, England	Senior Vice President and Chief Actuary
A. Louis Parker #	Overland Park, Kansas	Exec. Vice President - Commercial Insurance
Richard F. Smith	Minnetonka, Minnesota	Executive Vice President - P&C Reinsurance
Alfred J.V. Stanley #	Leawood, Kansas	Executive Vice President - Global Life & Health
William J. Steilen	Overland Park, Kansas	Senior Vice President – Global Treasury

A. Louis Parker and Alfred J.V. Stanley resigned effective June 17, 2004

Mark E.M. Elborne was elected as a director effective March 1, 2004

Committees

The committees of the Board of Directors consist of an Executive Committee and an Investment Committee. These committees operate in accordance with the Company's Bylaws. The members of the committees as of December 31, 2003, were as follows:

<u>Executive Committee</u>	<u>Investment Committee</u>	
Ronald R. Pressman	Ronald R. Pressman	Richard F. Smith
Marc A. Meiches	Marc A. Meiches	Alfred J.V. Stanley
Richard F. Smith	Thomas A. Powers	Stephen DeVos
A. Louis Parker	Kieran Dempsey	Kathryn Karlic
	A. Louis Parker	Samira Barakat

Officers

The Board of Directors elect many Vice Presidents and Assistant Vice Presidents, which are too numerous to list in this report. The senior executive officers elected by the Board of Directors and serving as of December 31, 2003, were as follows:

Ronald R. Pressman	Chairman and Chief Executive Officer
A. Louis Parker#	President and Chief Operating Officer
John F. Frye	Senior Vice President and Chief Financial Officer
William E. Donnell*	Senior Vice President
Michael J. Gill	Senior Vice President
David G. Newkirk	Vice President, General Counsel, and Secretary
Kenneth J. Holferty	Treasurer

Effective June 17, 2004, A. Louis Parker resigned and was replaced by Richard F. Smith as President and Chief Operating Officer.

* William E. Donnell's term expired December 31, 2004 and was not reelected. Robin P. Sterneck was elected Senior Vice President, effective January 1, 2005.

Conflict of Interest

The Company has a policy that requires all officers, directors, and key employees to complete a conflict of interest statement each year. Signed statements of officers and directors were reviewed for the examination period. No significant exceptions were noted.

Corporate Records

A review was made of the Articles of Incorporation and Bylaws for the examination period. The Articles of Incorporation were not amended during the examination period. The Bylaws were amended on July 10, 2001 to change the required frequency of the Board of Directors' meetings from a quarterly basis to one annual meeting with the option for other meetings upon a Board resolution.

The minutes of the Board of Directors' meetings, committee meetings, and stockholders' meetings were reviewed for proper approval of corporate transactions. In general, the minutes appear to properly reflect and approve the Company's major transactions and events for the period under examination.

Acquisitions, Mergers and Major Corporate Events

None.

Surplus Debentures

No surplus debentures were issued or outstanding for the period under examination.

AFFILIATED COMPANIES

Holding Company, Subsidiaries and Affiliates

The Company is a member of an Insurance Holding Company System as defined by Section 382.010, RSMo (Definitions). An Insurance Holding Company System Registration Statement was filed by the Company's parent, ERC, on behalf of itself, FSIC, and ERC's other insurance subsidiaries, for each year of the examination period.

The Company has one small subsidiary, GE Insurance Solutions Agency, LLC (GEISA), that performs underwriting, policy issuance, and premium collection services for FSIC. The book value of GEISA, as of December 31, 2003, was only \$41,436.

First Specialty is directly owned 100% by ERC. ERC is one of the largest property and casualty reinsurers in the world. ERC's non-affiliated assumed business is mostly from casualty lines such as worker's compensation, disability, and other liability lines. Significant business is also assumed from ERC's European and U.S. subsidiaries, including WIC, and other affiliates. Below is description of the material subsidiaries of ERC.

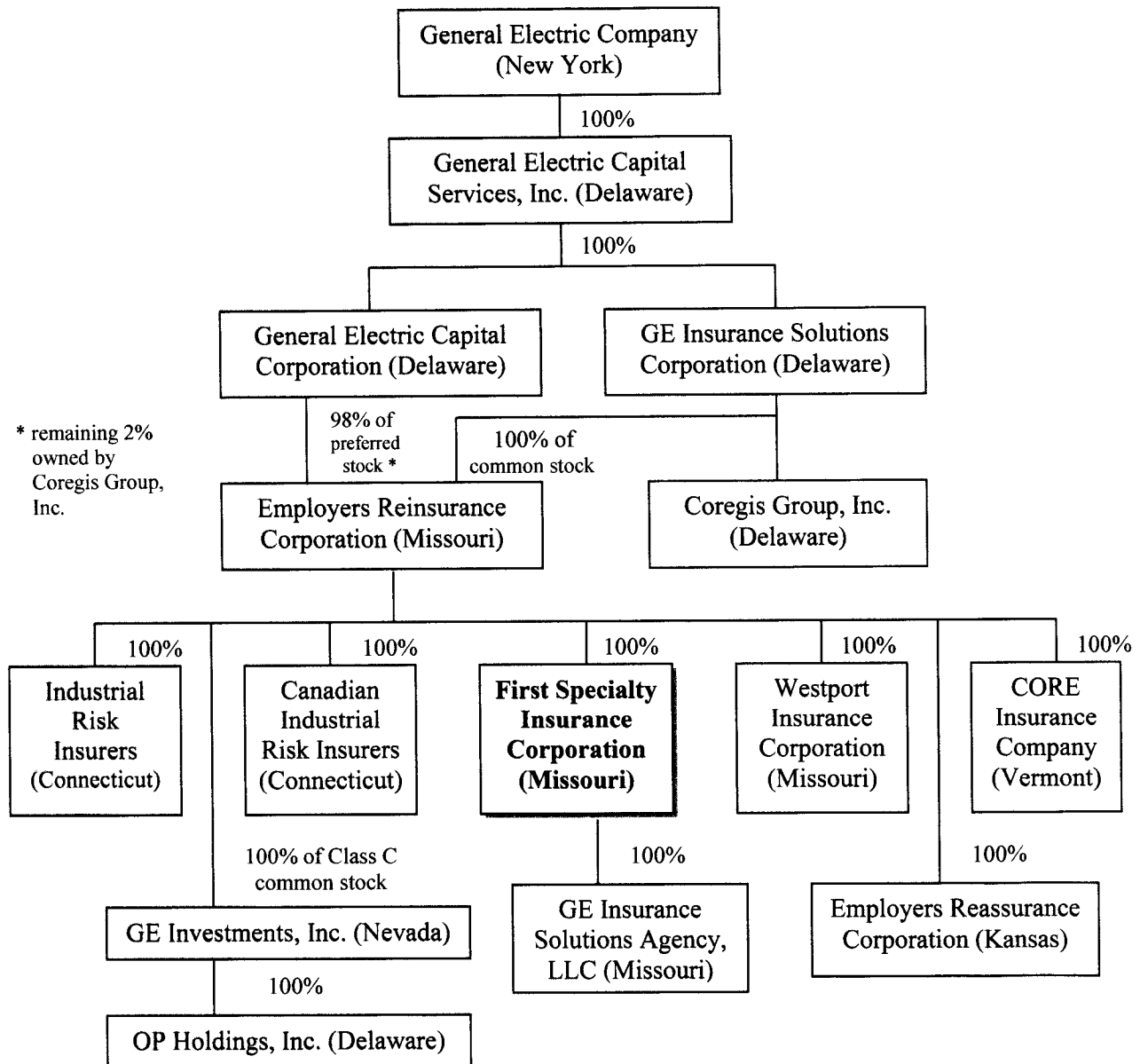
- Employers Reassurance Corporation (ERAC) is a life and health reinsurer.
- OP Holdings, Inc. is the holding company for over twenty insurance, reinsurance, and holding companies located mostly in Europe, including the United Kingdom, Ireland, Denmark, France, Germany, and Luxembourg. ERC owns OP Holdings through its 100% ownership of the Class C common stock of GE Investments, Inc.
- Westport Insurance Company (WIC) is a property and casualty insurer specializing in commercial lines of worker's compensation, lawyer's professional liability, general liability, property, crime, auto, and others.
- Industrial Risk Insurers (IRI) is an voluntary joint underwriting association in which ERC has a 99.5% direct membership interest. WIC has the remaining 0.5% direct membership interest, but has an agreement that assigns that interest to ERC. IRI writes large property risks usually involving multiple locations.
- Canadian Industrial Risk Insurers (Canadian IRI) is also a voluntary joint underwriting association in which ERC has a 100% membership interest. Canadian IRI writes the same types of policies as IRI, but in Canada only.
- Core Insurance Company is a property and casualty reinsurer, but does not have any active operations. All of its reinsurance agreements were novated to ERC, effective December 31, 2003.

ERC is directly controlled by GE Insurance Solutions Corporation, which owns 100% of ERC's common stock. GE Insurance Solutions is a holding company that owns several other insurance and reinsurance companies.

The ultimate controlling entity of FSIC is General Electric Company (GE), which is one of the largest organizations in the world. GE is a publicly traded stock company. GE consists of eleven operating segments, including GE Insurance Solutions. The other segments of GE are engaged in providing services or manufacturing in the following industries: commercial and consumer finance, aircraft engines and locomotives, energy industry technologies, consumer appliances, industrial lighting and electrical products, media and entertainment, plastics and advanced materials, power plant products, and medical technologies.

Organizational Chart

The following organizational chart depicts the ownership of FSIC and the significant subsidiaries owned by the parent, ERC, as of December 31, 2003.



Intercompany Agreements

The Company's intercompany agreements in effect, as of December 31, 2003 and subsequent periods, are outlined below.

1. **Type:** Service Agreement
Affiliate: ERC
Effective: December 7, 1989
Terms: ERC will provide office space, furniture and equipment and will provide the following services: data processing, computer services, accounting, financial, actuarial, legal, executive, personnel, payroll, sales, underwriting, claims and related services necessary to conduct the business of FSIC. First Specialty will reimburse ERC for ERC's reasonable and necessary expenses in connection with the provision of services. Amendment No. 1, dated June 26, 1996, includes an exhibit that shows the calculation of allocated expenses to FSIC. Allocation percentages are developed from methodologies, such as number of employees and amount of assets, to allocate the various types of expenses.

2. **Type:** Underwriting Management Agreement
Affiliate: CORE Managers, Inc. and WIC
Effective: June 1, 1996
Terms: CORE Managers, Inc. agrees to provide underwriting services to write various casualty lines of business for WIC and FSIC. CORE Managers, Inc. has the authority to solicit business, bind and write insurance contracts, determine premiums and brokerage commissions, and collect and account for premiums. Authorized lines of business include automobile liability, general liability, umbrella liability, workers' compensation, employers' liability, self-insured risks, captives, and risk retention groups. The maximum limits for policies written are \$5,000,000 per occurrence, except for workers compensation policies, which is \$10,000,000 per occurrence. WIC and FSIC will pay CORE Managers, Inc a monthly underwriting management fee that will be determined by mutual agreement among the parties.

3. **Type:** Operating Agreement
Affiliate: GE Insurance Solutions Agency, LLC (GEISA)
Effective: January 1, 1998
Terms: GEISA will provide the following services for FSIC: bind and write contracts of insurance, determine premium and commission amounts, policy issuance, and collect premiums. First Specialty will pay GEISA a monthly service fee equal to

its monthly operating expenses incurred in providing services or producing business for the Company.

4. Type: Service Agreement

Affiliate: The Medical Protective Company (Med Pro)

Effective: January 1, 1999

Terms: Med Pro will provide equipment and will provide the following services: data processing, computer services, accounting, financial, actuarial, executive, personnel, payroll, sales, underwriting, claims and related services necessary to conduct the business of FSIC. First Specialty will reimburse Med Pro for the amount of Med Pro's budgeted expenses and overhead in connection with providing the services. Compensation paid by FSIC shall be based upon a proportionate percentage of annual overhead, salary, and expenses of Med Pro personnel performing the services. Med Pro is also authorized to collect funds on behalf of FSIC and deposit the money into a FSIC bank account.

5. Type: Master Outsourcing Agreement

Affiliates: GE Insurance Solutions Corporation, GECIS, ERC, WIC, ERAC, GE Insurance Solutions Agency, LLC (GEISA), Industrial Risk Insurers (IRI), The Medical Protective Company (Med Pro), GE Re, Coregis Insurance Company, California Insurance Company, Coregis Indemnity Company

Effective: March 1, 1999

Terms: GECIS will provide the following business outsourcing services for the affiliates: data processing, administrative, actuarial, general accounting, treasury, financial reporting, technical accounting, filing approval notices, agents licensing, claims, underwriting, and other support services. GECIS shall prepare reports relating to performance of the services as reasonably requested. This agreement will be supplemented for each service to be provided by a specific Statement of Work (SOW) to establish in writing the scope of the services, performance standards, pricing and customer provided support for each project. The fees for the services provided shall be agreed to by the parties and incorporated within the individual SOWs.

A summary of the SOWs attached to this agreement in which FSIC is a named party is listed in the table below.

SOW No.	Effective Date	Services Provided by GECIS
2	May 1, 2000	Claims and underwriting support services
3	May 1, 2000	Cash allocation processes for receipts and disbursements
3a	May 1, 2000	Prepare 1099 forms to be sent to the Internal Revenue Service, payees, and states
3b	May 1, 2000	Prepare general ledger and bank reconciliations

3c	May 1, 2000	Prepare and file escheatment reports with various states
5	April 1, 2000	Profitability and financial analysis
7	November 30, 2000	Data entry for filings with rate service organizations
9	December 1, 2000	Premium tax calculations and prepare accruals
11	December 1, 2000	Perform reconciliations for statutory reporting
12	March 1, 2001	Actuarial analysis and support processes
16	September 1, 2001	Reinsurance transaction processing and reporting
17	October 26, 2001	General ledger account reconciliations
18	October 26, 2001	Accounting for receipts, disbursements, cash balancing
19	October 1, 2001	Claims and underwriting support services
21	June 1, 2000	Catastrophe exposure analysis and modeling
22	October 31, 2001	Agent receivable reconciliations and collections
32	February 20, 2002	Research, analysis, modeling for risk factors in the business operations
35	November 22, 2002	Pricing modeling, business portfolio analysis
41	January 23, 2004	Pricing, underwriting, binding, and issuance of policies
42	October 12, 2004	Implement a common financial reporting platform
43	September 12, 2004	Scheduling services, customer service center monitoring
44	September 21, 2004	Contract administration, corporate and regulatory support

6. Type: Service Mark Agreement

Affiliate: GE Insurance Solutions Corporation

Effective: January 1, 2000

Terms: GE Insurance Solutions has the right from GE to license the use of the GE logo and other licensed marks. GE Insurance Solutions grants a license to ERC to use the GE logo and other licensed marks. FSIC will pay an annual royalty of 0.125% of its total assets, as stated in its GAAP financial statements.

Exception: This Agreement was never filed for prior approval with the MDI, as required by Section 382.195 RSMo. (Transactions Within a Holding Company System). The Company is directed to immediately submit this Agreement as part of a Form D filing to the MDI for approval. Payments made by FSIC under this Agreement should cease until the Agreement is approved by the MDI.

7. Type: Service Agreement

Affiliate: WIC

Effective: October 1, 2000

Terms: WIC will provide equipment and will provide the following services: data processing, computer services, accounting, financial, actuarial, legal, executive, personnel, payroll, sales, underwriting, claims and related services necessary to conduct the business of FSIC. FSIC will pay WIC a monthly service fee equal to WIC's monthly operating expenses incurred in rendering the services. WIC is also authorized to collect funds on behalf of FSIC and deposit the money in a FSIC bank account.

8. Type: Computer Services Agreement

Affiliates: General Electric Company, ERC, WIC, ERAC

Effective: November 4, 2000

Terms: General Electric Company, acting through its Global Computer Operation Division (GCO), will provide the following computer services: operations, production control, technical services, database administration, data center / network disaster recovery, service level performance, and logical access control. Fees to be paid to GCO by FSIC and the other affiliates are based upon scheduled amounts listed in the agreement.

9. Type: Federal Tax Allocation Agreement

Affiliates: GE Insurance Solutions Corporation, WIC, FSIC, IRI Management Services, LLC, IRI Corporation, IRI Holdings

Effective: January 1, 2001

Terms: ERC and all other entities in the agreement are included in the consolidated tax return filed by General Electric Company. The federal tax liability of each affiliate shall be calculated on a separate return basis. The subsidiaries of ERC will remit tax payments to ERC. ERC then remits tax payments on behalf of itself and its subsidiaries to GE Insurance Solutions.

10. Type: Investment Management and Services Agreement

Affiliates: GE Asset Management Incorporated (GEAM), ERC, FSIC

Effective: May 1, 2002

Terms: GEAM will provide investment management services. The services will include research and identify investment opportunities, assist in developing an overall investment strategy, invest and sell assets in accordance with applicable laws and the investment guidelines of each entity, prepare quarterly reports of the purchases and sales of investments and present such reports to the Board of Directors or Investment Committee, and other services. ERC, WIC, and FSIC will pay GEAM a quarterly management fee equal to 0.053% of the value of the assets managed by GEAM.

11. Type: Consulting Agreement

Affiliates: iProcess International, LLC (iProcess), ERC, FSIC, ERAC, The Medical Protective Company, GE Re, Coregis Insurance Company

Effective: December 26, 2002

Terms: iProcess will provide the following consulting services: recommendations for improving and standardizing processes, resolving issues outside of standard operating procedures, forecasting operational needs, formulating and implementing outsourcing programs, obtaining outsourcing services, training personnel, and other services. ERC will reimburse iProcess for all of its reasonable costs incurred, including salaries and travel and living expenses, in providing the services for all of the affiliates. FSIC will reimburse ERC for its applicable portion of the total costs paid by ERC.

Exception: The Company could not provide a signed copy of the Consulting Agreement with iProcess. Therefore, the Agreement was apparently never formally executed since it was not signed by the parties. The Company is directed to immediately execute this Agreement and cease all transactions until the Agreement is executed.

12. Type: Parental Guarantee

Affiliate: ERC

Effective: June 30, 2003

Terms: ERC guarantees to reimburse First Specialty for 100% of any recoverables that are due to First Specialty under a reinsurance agreement from an external reinsurer, in the event that such recoverables become uncollectible. The Guarantee applies to all past, current, and future reinsurance agreements of the Company. ERC was paid \$10,000 from First Specialty as consideration for the Guarantee.

13. Type: Service Reimbursement Agreement

Affiliates: General Electric Company, ERC, FSIC, GE Re

Effective: April 8, 2004

Terms: The Global Business Services (GBS) division of GE will provide the following services: payroll, employee benefits, travel and living, and other services. ERC employees will participate in the GE Pension Plan and other GE benefit plans pursuant to this agreement. ERC will pay GBS for the direct costs attributable to its employees and an allocated amount for costs that are not directly attributable. ERC's allocated share is based upon the total annual compensation of ERC employees compared to the total for all GE employees. WIC, FSIC, and GE Re will reimburse ERC for each entity's respective actual or proportional share of the total costs paid by ERC.

In addition to the above listed agreements, FSIC has reinsurance agreements with ERC and other affiliates, which are described in the Reinsurance section of this report.

Intercompany Transactions

The following table summarizes the payments made during the exam period, between FSIC and its affiliates, pursuant to intercompany agreements.

Related Party	Agreement	Net Amount Paid / (Received) by FSIC		
		2001	2002	2003
ERC	Service	3,114,641	3,067,718	3,627,913
CORE Managers	Underwriting Management	0	0	0
GEISA	Operating Agreement	200,000	200,000	100,000
Med Pro	Service	0	0	0
GECIS	Various SOWs	22,522	399,235	1,058,101
GE Insur. Solutions	Service Mark	56,830	170,649	292,814
WIC	Service	0	0	0
GE	Computer Services	0	0	0
ERC	Federal Tax Allocation	4,055,988	4,442,611	(2,290,177)
GEAM	Investment Management	0	0	126,889
iProcess	Consulting	0	0	0
GE	Service Reimbursement	1,418,832	1,832,412	3,076,577
TOTAL		\$8,868,813	\$10,112,625	\$5,992,117

As indicated by the table above, the Company stated that there were no transactions during the examination period between FSIC and various affiliates, pursuant to the following intercompany agreements: Underwriting Management Agreement with CORE Managers, Service Agreement with WIC, Computer Services Agreement with GE, and the Consulting Agreement with iProcess and other affiliates. These Agreements do not appear to be necessary due to the lack of use during the examination period. The Company is directed to investigate the need for each of these Agreements. For any Agreements in which it is determined that there will not be any future transactions involving First Specialty, such Agreements should be either amended to remove First Specialty or terminated.

The Company could not provide a reconciliation to identify the amounts paid or received by First Specialty for each intercompany agreement that would support the payments with affiliates that were reported in Schedule Y – Part 2 of the 2003 Annual Statement. The accuracy of the reported amounts could not be verified without such a reconciliation. The Company is directed to implement accounting procedures to track the specific payments made or received by intercompany agreement for amounts reported in Schedule Y – Part 2.

The Company also received capital contributions totaling \$25,000,000 from ERC during 2002.

FIDELITY BOND AND OTHER INSURANCE

The Company's ultimate parent, GE, self-insures the first \$25,000,000 of fidelity insurance coverage for itself and all of its subsidiaries, including First Specialty. GE also has a crime insurance policy that provides fidelity coverage for all subsidiaries, including First Specialty, which has a liability limit of \$125,000,000 and a \$25,000,000 deductible. The suggested minimum level of coverage for FSIC, according to NAIC guidelines, is \$1,250,000 based upon admitted assets and premiums. The Company stated that there is no agreement with GE or any internal procedures whatsoever to define FSIC's financial responsibility in the event that FSIC should incur a fidelity loss. A \$25,000,000 deductible for FSIC is excessive, in comparison to the NAIC suggested minimum and the \$250,000 deductible that was in effect during the prior examination. The Company is directed to obtain an agreement whereby GE or ERC will agree to indemnify First Specialty for any fidelity losses in excess of \$250,000 up to the \$1,250,000 minimum level recommended by the NAIC. As an alternative, the Company could choose to obtain its own insurance policy to cover the first \$1,250,000 of exposure.

GE is also a named insured on several other insurance policies. Although First Specialty is not specifically named as an insured on most of these policies, the terms define coverage as being applicable to all subsidiaries of GE, which would include FSIC. These additional insurance policies are as follows: property, commercial general liability, commercial umbrella liability, workers compensation, employers' liability, employment practices liability, fiduciary liability, directors' and officers' liability, errors and omissions liability, and business auto.

PENSION, STOCK OWNERSHIP AND INSURANCE PLANS

The Company only had 35 of its own employees, as of May 2005, consisting mostly of underwriting personnel. First Specialty has outsourced most of the functions required to operate its business to other entities, pursuant to intercompany agreements. Various administrative functions of FSIC's business operations are conducted by employees of the direct parent, ERC, and the ultimate parent, GE. The management of its investment portfolio is performed by an affiliate, GE Asset Management Incorporated (GEAM). The investment accounting function is outsourced to State Street Bank and Trust Company (State Street), an unaffiliated entity. State Street is responsible for reconciling investment accounts to the G/L balances and preparing all statutory reports for investments such as Schedule D, DA, BA, and E - Part 2 of the Annual Statement. GECIS, an affiliate located in India, performs various services that include accounting, actuarial, claims, data entry, financial analysis, underwriting, and several other services. Refer to the Intercompany Agreements and Intercompany Transactions sections of this report for a review of FSIC's affiliated agreements and transactions.

Benefits provided to FSIC, ERC, and GE employees include health insurance, dental insurance, vision insurance, disability insurance, long-term care insurance, life insurance, medical and child care flexible spending accounts, and a 401(k) savings plan with matching contributions. All employees are covered by two separate defined benefit pension plans. Those employees vested prior to October 1, 1999 are covered by the ERC Retirement Plan, while those employees vested on or after October 1, 1999 are covered by the General Electric Pension Plan. The benefits vary between the two pension plans. Post-retirement benefits are also provided to retirees.

STATUTORY DEPOSITS

Deposits with the State of Missouri

The funds on deposit with the Missouri Department of Insurance, as of December 31, 2003, were sufficient to meet the capital deposit requirements for the State of Missouri in accordance with Section 379.098 RSMo (Securities Deposit). The funds on deposit as of December 31, 2003, were as follows:

<u>Type of Security</u>	<u>Par Value</u>	<u>Fair Value</u>	<u>Statement Value</u>
State Bond	\$2,600,000	\$2,597,236	\$2,597,236

Deposits with Other States

The Company also has funds on deposit with other states. Those funds on deposit as of December 31, 2003, were as follows:

<u>State</u>	<u>Type of Security</u>	<u>Par Value</u>	<u>Fair Value</u>	<u>Statement Value</u>
Arkansas	Municipal Bonds	425,000	470,719	470,719
Louisiana	U.S. Treasury Note	100,000	106,906	100,892
Massachusetts	State Bond	700,000	729,943	729,943
New Hampshire	U.S. Treasury Note and State Bonds	550,000	572,285	562,229
New Jersey	U.S. Treasury Note	200,000	222,938	201,166
New Mexico	U.S. Treasury Note	125,000	139,336	125,728
New York	U.S. Treasury Note, Cash, State and Municipal Bonds	2,832,400	2,994,053	2,835,648
Oklahoma	Municipal Bond	110,000	112,571	112,172
South Carolina	U.S. Treasury Note	150,000	167,063	150,403
Total		<u>\$5,192,400</u>	<u>\$5,515,814</u>	<u>\$5,288,900</u>

INSURANCE PRODUCTS AND RELATED PRACTICES

Territory and Plan of Operation

First Specialty is licensed as a property and casualty insurer by the Missouri Department of Insurance under Chapter 379 RSMo (Insurance Other than Life). The Company is not licensed in any other states. However, the Company writes business in the other forty-nine states and the District of Columbia on an excess and surplus lines basis. The states with the largest percentage of direct written premiums for 2003 were California (14.2%), Florida (11.6%), and Texas (10.3%).

FSIC is a direct insurer only with no assumed business. The major lines of direct business, based upon 2003 written premiums, are as follows:

<u>Line of Business</u>	<u>Percentage of Direct Written Premiums</u>
Other Liability – Occurrence	41.6%
Commercial Multiple Peril	22.3%
Medical Malpractice – Claims Made	16.9%
Inland Marine	8.2%
All Other	<u>10.0%</u>
Total	100.0%

The Company and other affiliated insurance companies, including the direct parent, ERC, are managed as “GE Insurance Solutions.” There are three main profit and loss (P&L) centers of GE Insurance Solutions, as follows: (1) Global Life and Health, (2) P&C Reinsurance, and (3) Commercial Insurance. Global Life and Health consists of ERC’s subsidiary, ERAC, and other European affiliated insurers. P&C Reinsurance consists of ERC, its European subsidiary reinsurers, and an affiliate, GE Reinsurance Corporation. FSIC is included in the Commercial Insurance P&L center along with ERC and its subsidiaries, WIC and IRI.

The Commercial Insurance P&L center is divided into sub-P&L’s as follows: (1) Healthcare, (2) Specialty, (3) Industrial Risk Insurers, and (4) P&C Select. Another sub-P&L, Medical Protective, existed at December 31, 2003, but was eliminated as a result of General Electric’s sale of The Medical Protective Company to Berkshire Hathaway in May 2005. All of the Company’s business is from the Healthcare, Specialty, and P&C Select sub-P&L’s.

In the Healthcare sub-P&L center, First Specialty provides hospital professional liability insurance for acute care facilities with 75 beds or more. In most jurisdictions, coverage is provided on a claims made basis.

In the Specialty center, the Company writes lawyers’ professional liability coverages. Law firms that have between 1 and 250 lawyers are targeted with preferred areas of practice in select geographic areas.

First Specialty participates in three segments of the P&C Select center – “Lynx”, Program Managers, and General Binding Authorities. The Lynx segment represents wind and earthquake insurance. The wind insurance is sold in the southeastern United States and the earthquake insurance is sold mostly in California and Oregon. Targeted customers are apartments, condominiums, and office buildings.

The Program Managers segment focuses on providing commercial insurance coverage for niche customer groups such as financial planners, habitational owners, and security guard agencies. The business is written through Program Managers that are third party Managing General Underwriters (MGUs). The MGUs have the authority to underwrite and issue general liability, property, and umbrella policies. The Program Managers administer the programs and work directly with independent insurance agents. The average general liability limit is \$1 million per occurrence with property limits up to \$10 million.

The General Binding Authorities segment utilizes 28 agents that use the same underwriting guidelines. Each agent has binding authority and is allowed to write general liability up to \$1 million per occurrence and property coverages up to \$10 million. Typical customers are apartments, real estate, restaurants, and retail establishments.

The Company’s direct policies are produced by an agency force consisting of 501 licensed independent agents.

Policy Forms & Underwriting
Advertising & Sales Materials
Treatment of Policyholders

The Missouri Department of Insurance has a market conduct staff that performs a review of these issues and generates a separate market conduct report. However, no market conduct examination reports from the MDI or any other state were issued for the examination period.

REINSURANCE**Premium Activity**

The Company's premium activity on a direct written, assumed and ceded basis, for the period under examination, is detailed below:

	<u>2001</u>	<u>2002</u>	<u>2003</u>
Direct Business	\$160,411,023	\$308,038,835	\$349,397,692
Reinsurance Assumed:			
Affiliates	0	0	0
Non-affiliates	0	0	0
Reinsurance Ceded:			
Affiliates	(64,048,408)	(185,259,582)	(271,028,394)
Non-affiliates	<u>(15,695,767)</u>	<u>(48,305,757)</u>	<u>(49,203,810)</u>
Net Written Premiums	<u>\$80,666,848</u>	<u>\$74,473,496</u>	<u>\$29,165,488</u>

Assumed

The Company does not assume any business.

Ceded

The Company is contingently liable for all reinsurance losses ceded to others. This contingent liability would become an actual liability in the event that an assuming reinsurer fails to perform its obligations under the reinsurance agreement.

First Specialty only retains small amounts of risk for the direct policies that it issues. The business reported as ceded to the Company's parent, ERC, accounted for most of First Specialty's 2003 total ceded premiums and ceded reserves, as of December 31, 2003. Below are the amounts reported by FSIC in the 2003 Annual Statement:

<u>Description</u>	<u>Amount</u>	<u>Percentage of Total</u>
2003 Premiums Ceded to ERC	\$271,100,000	84.7%
Loss and LAE Reserves Ceded to ERC	286,682,000	84.7%

The significant reinsurance agreements between First Specialty and ERC are described as follows.

The Company has four separate Quota Share Reinsurance Agreements with ERC. Three of the Agreements are effective December 31, 2001 and the other is effective June 30, 2002. Under the nearly identical terms of all four agreements, First Specialty cedes 100% of the premiums and losses for the following four lines of business: general liability and property coverages for small commercial businesses in the “GA Authority Excluding Windward” program, general liability policies for security guard firms in the “Costanza” MGA program, general liability and umbrella policies for construction and manufacturing businesses in the “Individual Risk Casualty” program, and comprehensive risk coverage for municipalities and school districts in the “Public Entity” program. First Specialty receives a ceding commission, which ranges from 15% to 26%, under the terms of the Agreements.

First Specialty has a Whole Account Aggregate XOL Contract with ERC, which was effective January 1, 2003. Pursuant to the terms of the Contract, the Company cedes 80% of the premiums and losses for all lines of business sold or assumed by First Specialty, excluding medical malpractice. The Company cedes 100% of premiums and losses for the medical malpractice business. The terms of this Contract are applied after the four 100% quota share Agreements with ERC. The business originally ceded 100% to ERC in the four quota share Agreements, is reduced to 80% in this Contract by crediting First Specialty for the 20% difference. First Specialty receives an 8% ceding commission for any net amounts ceded to ERC.

The Company has over 100 facultative reinsurance agreements with ERC to cede risks for policies issued to hospitals and other health care providers. The risks ceded include professional liability, excess liability, umbrella liability, and other liability coverages. The Company generally has a small retention in the facultative agreements with most of the premiums and risks being ceded to ERC.

For each year (2001 to 2003) in the examination period, First Specialty had a Whole Account Aggregate XOL Retrocession Contract with ERC. Under the terms of these Contracts, First Specialty would cede any losses on the Company’s entire book of business that exceeded a defined loss ratio. The Company’s retentions were all losses up to loss ratios of 72%, 60%, and 54% for the 2001, 2002, and 2003 accident years, respectively. Any net losses in excess of these loss ratios would be ceded to ERC up to a maximum limit of \$10,000,000 for 2001 and \$25,000,000 for 2002 and 2003. The premium to be paid by First Specialty would equal 52% of any losses ceded for each Contract with minimum premiums of \$550,000, \$400,000, and \$500,000 for the 2001, 2002, and 2003 accident years, respectively.

The Company also has an Adverse Development Agreement with First Specialty, effective June 30, 2003, that applies to the 2002 and prior accident years. ERC and First Specialty agreed that, as of June 30, 2003, First Specialty’s cumulative paid losses and loss adjustment expenses (LAE), excluding unallocated LAE, plus the remaining loss and LAE reserves for the 2002 and prior accident years equaled \$168,537,000. The Agreement states ERC will reimburse First Specialty for any paid losses and LAE for the 2002 and prior accident years that exceed \$168,537,000. First Specialty paid a \$1,000,000 premium to ERC as consideration for the coverage provided.

ACCOUNTS AND RECORDS

The CPA firm, KPMG, LLP, of Kansas City, Missouri, issued audited statutory financial statements of the Company for all years in the examination period.

The actuarial opinion regarding the Company's reserves for losses and loss adjustment expenses was issued by Roger A. Atkinson, FCAS, MAAA, for all years in the examination period. Mr. Atkinson is employed by the Company as the Chief Actuary, a position that is elected annually by the Board of Directors.

The Company closes its books and records for year-end transactions prior to December 31 of each year. FSIC's ultimate parent, GE, requires its subsidiaries to provide early financial statement information to facilitate timely reporting of GE's consolidated financial statements. Thus, most of the assets and liabilities reported in the 2003 Annual Statement are not the balances as of December 31, 2003. For example, invested asset balances represent holdings as of December 17, 2003. Direct premiums, case loss reserves, and cash accounts represent balances as of December 18, 2003. Other timing problems occur from the information reported from ceding companies on reinsurance assumed business. The Company is directed to disclose its accounting practice for reporting asset and liability balances with dates prior to December 31 in the Notes to the Financial Statement section of the Annual Statement. Such disclosure is required by SSAP No. 1, paragraph 5. Each year, the various cut-off dates that are used should be disclosed and the applicable asset and liabilities that are affected by each cut-off date.

FINANCIAL STATEMENTS

The following financial statements, with supporting exhibits, present the financial condition of First Specialty Insurance Corporation for the period ending December 31, 2003. Any examination adjustments to the amounts reported in the financial statements and/or comments regarding such are made in the "Notes to the Financial Statements." The failure of any column of numbers to add to its respective total is due to rounding or truncation.

There may have been additional differences found in the course of this examination, which are not shown in the "Notes to the Financial Statements." These differences were determined to be immaterial concerning their effect on the financial statements, and therefore, were only communicated to the Company and noted in the workpapers for each individual Annual Statement item.

Assets as of December 31, 2003

	<u>Assets</u>	<u>Non-Admitted Assets</u>	<u>Net Admitted Assets</u>
Bonds	\$186,003,055	\$0	\$186,003,055
Cash and Short-Term Investments	21,601,141	0	21,601,141
Other Invested Assets	41,436	0	41,436
Receivable for Securities	1,256,477	0	1,256,477
Investment Income Due and Accrued	2,393,791	0	2,393,791
Uncollected Premiums and Agents' Balances in the Course of Collection (Note 1)	41,061,450	8,598,752	32,462,698
Deferred Premiums, Agents' Balances Booked But Deferred and Not Yet Due	761,659	5,139	756,520
Amounts Recoverable from Reinsurers	25,409,353	0	25,409,353
Federal Income Tax Recoverable	372,643	0	372,643
Net Deferred Tax Asset	7,962,291	2,152,690	5,809,601
Receivables from Parent, Sub., and Affiliates	337	0	337
Aggregate Write-Ins: Other Assets	<u>50,000</u>	<u>50,000</u>	<u>0</u>
TOTAL ASSETS	<u>\$286,913,633</u>	<u>\$10,806,581</u>	<u>\$276,107,052</u>

Liabilities, Surplus and Other Funds as of December 31, 2003

Losses (Note 2)	\$ 46,852,916
Loss Adjustment Expenses (Note 2)	15,163,629
Commissions Payable	1,061,460
Other Expenses	753,054
Taxes, Licenses and Fees	26,073
Unearned Premiums	18,637,586
Advance Premiums	202,284
Ceded Reinsurance Premiums Payable	83,063,953
Funds Held by Company Under Reinsurance Treaties	466,502
Remittances and Items Not Allocated (Note 1)	22,082,336
Provision for Reinsurance (Note 3)	6,653,845
Payable to Parent, Subsidiaries and Affiliates	16,657
Payable for Securities	6,406,635
Aggregate Write-Ins for Liabilities	<u>639,747</u>
TOTAL LIABILITIES	\$202,026,677
Common Capital Stock	5,000,000
Gross Paid In and Contributed Surplus	41,000,000
Unassigned Funds (Surplus)	<u>28,080,375</u>
Capital and Surplus	<u>\$74,080,375</u>
TOTAL LIABILITIES AND SURPLUS	<u>\$276,107,052</u>

Statement of Income

For the Year Ended December 31, 2003

Premium Earned	\$36,904,952
DEDUCTIONS:	
Losses Incurred	18,953,349
Loss Expenses Incurred	15,466,238
Other Underwriting Expenses Incurred	<u>8,829,571</u>
Total Underwriting Deductions	<u>\$43,249,158</u>
Net Underwriting Loss	(\$6,344,206)
 Net Investment Income Earned	 7,204,479
Net Realized Capital Gains	<u>2,684,348</u>
Net Investment Gain	<u>\$9,888,827</u>
 Other Income	 49,250
Federal Income Taxes Incurred	<u>(3,711,781)</u>
 Net Income	 <u>\$7,305,652</u>
 CAPITAL AND SURPLUS ACCOUNT:	
Surplus as Regards Policyholders, December 31, 2002	\$63,547,512
Net Income	7,305,652
Change in Net Unrealized Capital Gains or (Losses)	(183,619)
Change in Net Deferred Income Tax	(4,519,257)
Change in Nonadmitted Assets	8,096,206
Change in Provision for Reinsurance	5,483,126
Examination Changes	<u>(5,649,245)</u>
Surplus as Regards Policyholders, December 31, 2003	<u>\$74,080,375</u>

Notes to the Financial Statements

Note 1 – Uncollected Premiums and Agents Balances	\$32,462,698
Remittances and Items Not Allocated	\$22,082,336

Suspense accounts for unapplied or mismatched cash receipts were incorrectly imbedded in the Uncollected Premiums line. Account No. 108080, titled "FSIC Batch Suspense", with a liability balance of \$13,966,831, represented batch totals of cash receipts received the last two days prior to the year-end cutoff date that had not been applied to specific policies. Account No. 108020, titled "ERMA Accts Rec", included suspense balances that totaled \$8,115,505 for items such as amounts paid in excess of balances due and payments received with a policy application. SSAP No. 67, paragraph 9, classifies these types of suspense amounts as Remittances and Items Not Allocated. An examination change was made to reclassify the \$22,082,336 of suspense balances from the Uncollected Premiums line to the Remittances and Items Not Allocated line. The Company is directed to properly report suspense accounts and suspense items, as defined in SSAP No. 67, paragraph 9, in the Remittances and Items Not Allocated line of the Annual Statement.

Note 2 – Losses	\$46,852,916
Loss Adjustment Expenses	\$15,163,629

The MDI engaged Expert Actuarial Services, LLC (EAS) to perform an actuarial review of the loss and loss adjustment expense reserves of First Specialty. EAS issued an actuarial opinion and report to the MDI and determined that FSIC's reported loss and LAE reserves of \$62,016,450, as of December 31, 2003, were reasonable on net basis. However, on a gross basis, EAS determined that the Company's loss and LAE reserves were deficient by \$58,000,000 (rounded).

EAS reviewed First Specialty's General Liability, Premises, and Operations (FSGLP) line of business, for which the Company recorded reserves of \$38,764,000. FSIC used a development factor to estimate the reserves for this line of business. EAS found that FSIC's selected development factor was not only lower than the average development factor from 1999 to 2003, but also lower than the development factor for any single year over the same period. The Company responded that its historical data for the FSGLP line of business was too inconsistent and that it applied a development factor that was based upon industry averages. EAS applied a development factor that more closely approximated the FSIC's historical averages and estimated the reserves for the FSGLP line to be \$96,521,000, which is \$57,757,000 greater than the reserves recorded by First Specialty.

EAS cited a quota share reinsurance agreement and an adverse development agreement with ERC that would eliminate any adverse development in the Company's loss and LAE reserves beyond amounts recorded, as of June 30, 2003. The gross deficiency of \$58,000,000 was reduced to zero on a net basis after applying the reinsurance agreements with ERC.

However, the Company is directed to review its reserving methodology for the FSGLP line of business. The Company should not disregard its own reserve development data even though it may have been deemed to be inconsistent or insufficient. Weight should be given to the Company's own reserve development in estimating the reserves for this line of business and all other lines of business. Management is further directed to ensure that the loss and LAE reserves are estimated conservatively in adherence to the concept of conservatism that is explained in paragraphs 29 and 30 of the Preamble to the Accounting Practices and Procedures Manual of the NAIC.

Note 3 – Provision for Reinsurance

\$6,653,845

The Provision for Reinsurance liability, as of December 31, 2003, had a reported balance of \$1,004,600. Amounts reported in Schedule F - Part 5, Provision for Unauthorized Reinsurance, are a component for determining the overall Provision for Reinsurance. Schedule F - Part 5 incorrectly reported "Other Allowed Offset Items" of \$7,326,000 for Core Reinsurance Company, Ltd. (Core Re), an affiliated Bermuda reinsurer. This item represents funds held in a trust account to collateralize unauthorized reinsurance recoverables from Core Re. The actual trust account balance, as of December 31, 2003, was \$1,676,755 or \$5,649,245 lower than the amount reported in Schedule F - Part 5. As a result, the Provision for Reinsurance was understated. An examination change was made to increase the Provision for Reinsurance by \$5,649,245. The Company is directed implement review procedures to ensure the accuracy of all amounts reported on Schedule F – Part 5.

Examination Changes

Capital and Surplus Per Company, December 31, 2003:

Common Capital Stock	\$ 5,000,000
Gross Paid In and Contributed Surplus	41,000,000
Unassigned Funds (Surplus)	<u>33,729,620</u>
Total Capital and Surplus Per Company	\$79,729,620

Examination Changes:

Reclassify Suspense Accounts** (Note 1)	\$ 0
Increase the Provision for Reinsurance (Note 3)	<u>(5,649,245)</u>
Total Examination Changes	(\$5,649,245)

Capital and Surplus Per Examination, December 31, 2003:

Common Capital Stock	\$ 5,000,000
Gross Paid-in and Contributed Surplus	41,000,000
Unassigned Funds (Surplus)	<u>28,080,375</u>
Total Capital and Surplus Per Examination	<u>\$74,080,375</u>

** No net surplus impact from this reclassification

General Comments and/or Recommendations

GE Service Mark Agreement (page 15)

The Service Mark Agreement with GE Insurance Solutions, effective January 1, 2000, was never filed for prior approval with the MDI, as required by Section 382.195 RSMo. (Transactions Within a Holding Company System). The Company is directed to immediately submit this Agreement as part of a Form D filing to the MDI for approval. Payments made by ERC under this Agreement should cease until the Agreement is approved by the MDI.

Intercompany Agreement Not Signed (page 17)

The Company could not provide a signed copy of the Consulting Agreement with iProcess and other affiliates. Therefore, the Agreement was apparently never formally executed since it was not signed by the parties. The Company is directed to immediately execute this Agreement and cease all transactions until the Agreement is executed.

Intercompany Agreements with No Transactions (page 18)

The Company stated that there were no transactions during the examination period between FSIC and various affiliates, pursuant to the following intercompany agreements: Underwriting Management Agreement with CORE Managers, Service Agreement with WIC, Computer Services Agreement with GE, and the Consulting Agreement with iProcess and other affiliates. These Agreements do not appear to be necessary due to the lack of use during the examination period. The Company is directed to investigate the need for each of these Agreements. For any Agreements in which it is determined that there will not be any future transactions involving First Specialty, such Agreements should be either amended to remove First Specialty or terminated.

Intercompany Payments Reported on Schedule Y (page 18)

The Company could not provide a reconciliation to identify the amounts paid or received by First Specialty for each intercompany agreement that would support the payments with affiliates that were reported in Schedule Y – Part 2 of the 2003 Annual Statement. The accuracy of the reported amounts could not be verified without such a reconciliation. The Company is directed to implement accounting procedures to track the specific payments made or received by intercompany agreement for amounts reported in Schedule Y – Part 2.

Fidelity Bond Insurance (page 19)

The Company's ultimate parent, GE, self-insures the first \$25,000,000 of fidelity insurance coverage for itself and all of its subsidiaries, including First Specialty. The suggested minimum level of coverage for FSIC, according to NAIC guidelines, is \$1,250,000 based upon admitted assets and premiums. The Company stated that there is no agreement with GE or any internal procedures whatsoever to define FSIC's financial responsibility in the event that FSIC should incur a fidelity loss. A \$25,000,000 deductible for FSIC is excessive, in comparison to the NAIC suggested minimum and the \$250,000 deductible that was in effect during the prior examination. The Company is directed to obtain an agreement whereby GE will agree to indemnify the Company for any fidelity losses in excess of \$250,000 up to the \$1,250,000 minimum level recommended by the NAIC. As an alternative, First Specialty could choose to obtain its own insurance policy to cover the first \$1,250,000 of exposure.

Year-End Reporting Dates (page 25)

The Company closes its books and records for year-end transactions prior to December 31 of each year. The Company is directed to disclose its accounting practice for reporting asset and liability balances with dates prior to December 31 in the Notes to the Financial Statement section of the Annual Statement. Such disclosure is required by SSAP No. 1, paragraph 5. Each year, the various cut-off dates that are used should be disclosed and the applicable asset and liabilities that are affected by each cut-off date.

Reporting of Suspense Items (pages 29)

Suspense accounts totaling \$22,082,336, as of December 31, 2003, for unapplied or mismatched cash receipts were incorrectly imbedded in the Uncollected Premiums line. SSAP No. 67, paragraph 9, classifies these types of suspense amounts as Remittances and Items Not Allocated. An examination change was made to reclassify the \$22,082,336 of suspense balances from the Uncollected Premiums line to the Remittances and Items Not Allocated line. The Company is directed to properly report suspense accounts and suspense items, as defined in SSAP No. 67, paragraph 9, in the Remittances and Items Not Allocated line of the Annual Statement.

Loss Reserves (pages 29 and 30)

The MDI engaged Expert Actuarial Services, LLC (EAS) to perform an actuarial review of the loss and loss adjustment expense reserves of First Specialty. EAS issued an actuarial opinion and report to the MDI and determined that FSIC's reported loss and LAE reserves of \$62,016,450, as of December 31, 2003, were reasonable on net basis. However, on a gross basis, EAS determined that the Company's loss and LAE reserves were deficient by \$58,000,000 (rounded). The source for this deficiency was the FSGLP line of business, for which the Company recorded reserves of \$38,764,000. FSIC used a development factor based upon industry averages to estimate the reserves for this line of business. EAS used development factors based upon the historical development data for the FSGLP line of business.

Although there was no net impact on capital and surplus from EAS' findings, the Company is directed to review its reserving methodology for the FSGLP line of business. The Company should not disregard its own reserve development data even though it may have been deemed to be inconsistent or insufficient. Weight should be given to the Company's own reserve development in estimating the reserves for this line of business and all other lines of business. Management is further directed to ensure that the loss and LAE reserves are estimated conservatively in adherence to the concept of conservatism that is explained in paragraphs 29 and 30 of the Preamble to the Accounting Practices and Procedures Manual of the NAIC.

Provision for Reinsurance (pages 30)

The Provision for Reinsurance liability, as of December 31, 2003, had a reported balance of \$1,004,600. Amounts reported in Schedule F - Part 5, Provision for Unauthorized Reinsurance, are a component for determining the overall Provision for Reinsurance. Schedule F - Part 5 incorrectly reported "Other Allowed Offset Items" of \$7,326,000 for Core Reinsurance Company, Ltd. (Core Re), an affiliate. The actual trust account balance, as of December 31, 2003, was \$1,676,755 or \$5,649,245 lower than the amount reported in Schedule F - Part 5. As a result, the Provision for Reinsurance was understated. An examination change was made to increase the Provision for Reinsurance by \$5,649,245. The Company is directed to implement review procedures to ensure the accuracy of all amounts reported on Schedule F – Part 5.

SUBSEQUENT EVENTS**Hurricane Activity**

A series of large hurricanes occurred in 2004 and 2005 that caused material losses for FSIC. Estimated losses from Hurricanes Charley, Frances, Ivan, and Jeanne in 2004 totaled \$161,000,000 on a gross basis and \$23,000,000 net of reinsurance. Estimated losses from Hurricane Katrina in 2005 were \$10,000,000 on a gross basis and \$1,000,000 net of reinsurance. Loss estimates were the latest information provided as of the date of this report.

Acquisition by Swiss Re

On November 18, 2005, it was announced that GE had agreed to sell First Specialty's parent holding company, GE Insurance Solutions, to Swiss Reinsurance Company (Swiss Re) for \$6.8 billion. No transactions have been proposed in conjunction with the acquisition, which would significantly affect the organizational structure or business operations of First Specialty. FSIC will strengthen its reserves for loss and loss adjustment expenses by approximately \$5,000,000, due to deficiencies identified by the Company and Swiss Re, as a condition of the purchase agreement. The sale is expected to close in mid-2006 after regulatory approvals have been received.


ACKNOWLEDGMENT

The assistance and cooperation extended by the officers and the employees of First Specialty Insurance Corporation during the course of this examination is hereby acknowledged and appreciated. In addition to the undersigned, Leslie Nehring, Angela Campbell, CFE, Bernie Troop, CFE, Al Garon, CFE, Karen Baldree, CFE, and Andy Balas, CFE, examiners for the Missouri Department of Insurance, participated in this examination. The firm of Expert Actuarial Services, LLC, also participated as a consulting actuary.

VERIFICATION

State of Missouri)
)
County of Boone)

I, Tim L. Tunks, on my oath swear that to the best of my knowledge and belief the above examination report is true and accurate and is comprised of only facts appearing upon the books, records or other documents of First Specialty Insurance Corporation, its agents or other persons examined or as ascertained from the testimony of its officers or agents or other persons examined concerning its affairs and such conclusions and recommendations as the examiners find reasonably warranted from the facts.


Tim L. Tunks, CPA, CFE
Examiner-In-Charge
Missouri Department of Insurance

Sworn to and subscribed before me this 16th day of February, 2006.

My commission expires:

May 1, 2008

Debbie J. Nolke
Notary Public

DEBBIE J. NOLKE
Notary Public - Notary Seal
STATE OF MISSOURI
County of Boone
My Commission Expires May 1, 2008

William W. Viner, Jr.
William W. Viner, Jr., CFE
Examiner
Nevada Division of Insurance
Western Zone, NAIC

SUPERVISION

The examination process has been monitored and supervised by the undersigned. The examination report and supporting workpapers have been reviewed and approved. Compliance with NAIC procedures and guidelines as contained in the Financial Condition Examiners Handbook has been confirmed.

Frederick G. Heese
Frederick G. Heese, CFE, CPA
Audit Manager
Missouri Department of Insurance



GE Insurance Solutions

Employers Reinsurance Corporation
9201 State Line Road
Kansas City, MO 64114
USA

April 28, 2006

VIA EXPRESS MAIL SERVICE

Mr. Kirk Schmidt
Chief Financial Examiner
Division of Financial Regulation
Missouri Department of Insurance
301 West High, Room 630
Jefferson City, MO 65101

RECEIVED

MAY 5 2006

DIVISION
FINANCIAL REGULATION

Re: Draft Report of Association Financial Examination (as of December 31, 2003)
First Specialty Insurance Corporation

Dear Mr. Schmidt,

First Specialty Insurance Corporation (FSIC) is in receipt of the draft of the above-captioned report dated February 8, 2006 and provided to us for review on April 10, 2006. FSIC appreciates the opportunity to review the report and provide comments. Accordingly, FSIC respectfully requests that this letter be incorporated into or attached to the final financial examination report of the Missouri Department of Insurance (MDI).

In providing comments, FSIC discusses each item in the order in which it was presented in the General Comments and/or Recommendations section of the draft examination report:

GE Service Mark Agreement: The draft report stated that the Service Mark Agreement between FSIC and GE Insurance Solutions Corporation, effective January 1, 2000, was not filed for prior approval through a Form D filing. The report includes a draft directive for FSIC to do so. On March 24, 2006, FSIC submitted a Form D to MDI concerning this agreement; on April 24, 2006, MDI issued a letter of non-disapproval with respect to this transaction.

Intercompany Agreement Not Signed: The draft report stated that FSIC could not provide a signed copy of a Consulting Agreement with iProcess International, LLC (iProcess). The report includes a draft directive for FSIC to execute this agreement. FSIC notes that the Consulting Agreement with iProcess has been terminated.

Intercompany Agreements with No Transactions: The draft report stated there were several intercompany agreements pursuant to which there appeared to be no transactions during the examination period. The report includes a draft directive for FSIC to investigate the need for each of the agreements, and amend or terminate the agreements as necessary. FSIC notes that the pending sales transaction between General Electric Company (GE) and Swiss Reinsurance Company (Swiss Re), through which FSIC is being sold to Swiss Re, may lead to an alteration of FSIC's affiliate contract arrangements. In relation to that transaction, FSIC is currently undertaking an examination of its

intercompany agreements. FSIC will make the necessary changes to existing intercompany agreements, but notes that there may be reasons for keeping agreements in place even where there has not been recent transaction activity.

Intercompany Payments Reported on Schedule Y: The draft report stated that FSIC could not provide a reconciliation to identify amounts paid or received for each intercompany agreement that would support payments reported on Schedule Y, Part 2 of the 2003 Annual Statement. The report includes a draft directive to implement procedures to track specific payments made or received by intercompany agreements for amounts reported in Schedule Y, Part 2. In 2005, FSIC implemented new procedures to ensure the accurate completion of Schedule Y, Part 2. These procedures address intercompany transactions relating to cost sharing agreements with affiliates.

Fidelity Bond Insurance: The draft report discusses GE's fidelity insurance coverage for itself and its subsidiaries, and states that the \$25,000,000 deductible potentially applicable to FSIC is excessive. The report includes a draft directive for FSIC to obtain an agreement whereby GE or ERC will indemnify FSIC for any fidelity losses in excess of \$250,000 up to the \$1,250,000 level recommended by NAIC guidelines or obtain its own insurance policy to cover the first \$1,250,000 of exposure. Within the context of the pending GE-Swiss Re transaction, FSIC will undertake a thorough evaluation of its insurance coverage, and expects to implement any changes that may remain necessary to comply with NAIC guidelines.

Year-End Reporting Dates: The draft report stated that timing problems occur because of FSIC's practice of closing its books and records prior to December 31. The report includes a draft directive for FSIC to disclose its accounting practice for reporting asset and liability balances with dates prior to December 31 in the Notes to the Financial Statement section of the Annual Statement. Beginning with the 2005 Annual Statement, FSIC disclosed in the Notes to the Financial Statements its accounting practice of reporting asset and liability balances with dates prior to December 31.

Reporting of Suspense Items: The draft report states that suspense accounts for unapplied or mismatched cash receipts were incorrectly imbedded in Uncollected Premiums line of the Annual Statement. The report also included an examination change of \$22,082,336 to reclassify this amount to the Remittances and Items Not Allocated line. The report further included a draft directive for FSIC to properly report suspense accounts and suspense items in Remittances and Items Not Allocated line of Annual Statement. Beginning with the 2005 Annual Statement, FSIC reported unapplied or mismatched cash receipts included in Uncollected Premium as Remittances and Items Not Allocated in accordance with Statement of Statutory Accounting Procedure No. 67, paragraph 9.


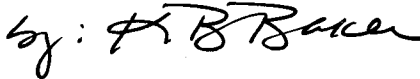
Loss Reserving Practices: The draft report discussed MDI's engagement of Expert Actuarial Services, LLC (EAS) to perform an actuarial review of FSIC's loss and loss adjustment expense (LAE) reserves. EAS reported a gross loss and LAE reserve deficiency as of December 31, 2003 of approximately \$58,000,000, the source of which was the FSGLP line of business. The report includes draft directives for FSIC to review the reserving methodology for this line of business and for FSIC management and to ensure reserves are conservatively estimated. With respect to the FSGLP line of business, the loss development pattern assumptions were reviewed consistently with the general process utilized in the 2005 reserve analysis. Assumptions were more conservative with a move away from industry loss development pattern assumptions to internal development patterns for most maturities. The net impact was insignificant as FSIC posted a small net ultimate loss decrease in 2005. Further, FSIC regularly conducts rigorous reviews of its reserve position, and FSIC management remains committed to ensuring FSIC possesses adequate reserves in relation to its liabilities.

Page 3
April 28, 2006
Mr. Kirk Schmidt

Provision for Reinsurance: The draft report stated that Schedule F, Part 5 of the Annual Statement incorrectly reported Other Allowed Offset Items of \$7,326,000 for CORE Reinsurance Company, Ltd. Because the actual trust account balance was found to be \$1,676,755, an examination change was made to increase the Provision for Reinsurance by \$5,649,245. The report includes a draft directive for FSIC to implement procedures to ensure accuracy of all amounts reported in Schedule F, Part 5. FSIC implemented new procedures in 2005 to ensure the accuracy of all amounts reported on Schedule F, Part 5. Such procedures include a detailed review by the appropriate stakeholders of Other Allowed Offset amounts.

FSIC appreciates the opportunity to provide these comments for consideration by MDI and inclusion in the final examination report. While FSIC reserves the right to re-visit its proposed course of action following the close of the GE-Swiss Re transaction, we look forward to working with MDI in resolving any issues for which corrective action is required. If you have any comments or questions regarding these comments, please let us know.

Sincerely,


by: 

Mark Elborne
General Counsel